BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appsals)
)
of)
)
MARGARET R. VAN CLEAVE and)
JULES V. VAN CLEAVE)

Appearances:

For Appellant: Murray M. Chotiner, Attorney at Law

For Respondent: Burl D. Lack, Chief Counsel;
Paul L. Ross, Associate Tax Counsel;
John S. Warren, Associate Tax Counsel.

O P I N I O N

These appeals are made pursuant to Section 18593 of the Revenue and Taxation Coda from the'action of the Franchise Tax Board on the protests of Margaret R. Van Cleave and Jules V. Van Cleave to proposed assessments of additional personal income tax in the amount of $4,969.93 against each of the Appellants for the year 1951.

Appellants, husband and wife, filed separate tax returns for the year 1951. The only income reported by Appellant Margaret R. Van Cleave was her share of the community income. (Hereinafter all references to Appellant in the singular will mean Jules V. Van Cleave,)

One of Appellant's income-producing activities during 1951 was the business of bookmaking, which he conducted from January to October 31 of that year, He operated the type of bookmaking business known as a "phone spot." Bets on horse races were telephoned in by his patrons, If the bettor won, Appellant paid him the amount of his winnings,, If the bettor lost, Appellant collected from the bettor the amount of the bet. Settlements fc bets won and lost were made with each bettor at intervals of approximately one week,

When a bet was placed Appellant or one of his employees recorded the transaction on a sheet of paper, a separate sheet being used daily for each bettor,' At the end of each day Appellant computed his net winnings or losses on each sheet and then made what is described as a top sheet, showing the outcome for th day. At the end of each week the daily sheets were consolidated

and the total winnings or losses of the bettor for the week were entered on a weekly top sheet. He then destroyed the daily records to avoid having incriminating evidence which might be use in the prosecution of a violation of Section 337(a) of the Penal Code.

At the end of each month Appellant prepared a monthly top sheet indicating the total winnings or losses of the bettors for the month and destroyed the weekly top sheets; At the close of the year the information from the monthly records showing the win nings *or* losses of the bettors for the year was turned over to Appellant's accountant for the purpose of preparing Appellants' income tax returns, and the monthly records were then destroyed.

On their 1951 returns Appellants each reported as "gross earnings" from bookmaking one-half of $45,754.20. This figure represented Appellants' aggregate net winnings, i.e., excess of bets won over bets lost, during the year. Deductions were taken therefrom in the'amounts of $7,605.00 for salaries and wages, $2,270.00 for rent and telephone and $525.00 for automobile expense, leaving a reported "net profit's of $35,354.20.

The Franchise Tax Board recomputed Appellants taxable income from bookmaking upon the basis that no deductions were allo able for expenses paid or incurred,, or for bets lost, subsequent to the effective date of Section 17359 of the Revenue and Taxati Code (May 3, 1951). Accordingly, that board issued the proposed assessments which are the subject of these appeals,

Inasmuch as Appellant kept no records which would show the total amount paid out on bets lost, the Franchise Tax Board estimated this amount, Its estimate was based on the premise that Appellant took bets at the track odds. Statistical data fro the Tenth Biennial Report of the California Horse Racing Board show that an average of 86 percent of the total pari-mutuel pool at California tracks is returned to the patrons, On this basis, the amount paid out in 1951 by Appellant on bets lost was compute as follows:

Net winnings ÷ 0.14 - Net Winnings = Amount paid out, or, applying the formula to reported net winnings,
$45,754.20 ÷ 0.14 - 45,754.20 = $281,061.52.

Six-tenths of this last figure, or $168,636.90, representing the total paid out during the months of May through October (the months following the effective date of Section 17359 during whic Appellant was engaged in bookmaking) and six-tenths of Appellant' reported bookmaking expenses, representing the bookmaking expens during the months of May through October, were added to Appellant's reported income. As so computed the Appellant's taxable income from the bookmaking business was increased by $174,879.90.

The first issue for determination herein is whether Section 17359 of the Revenue and Taxation Code prohibits deduction of expenses and wagers lost in computing taxable income derived from illegal bookmaking activities. Prior to the enactment of Section 17359 the matter of the deductibility of gambling losses was controlled exclusively by Section 17308, These sections and the position of each in the law may be set out as follows:

"Chapter 4. Deductions from Gross Income

Article 1. Items Deductible

* * * *

17308. Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.

* * * *

Article 2. Items Not Deductible

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17359. In computing net income, no deductions shall be allowed to any taxpayer on any of his gross income derived from illegal activities as defined in Chapters 9, 10 or 10.5 of Title 9 of Part 1 of the Penal Code, of California; nor shall any deductions be allowed to any taxpayer on any of his gross income derived from any other activities which tend to promote or to further, or are connected or associated with, such illegal activities." (Added by Stats. 1951, p. 4.96, effective May 3, 1951.)

Under the provisions of Chapter 10 of Title 9 of Part 1 of the Penal Code, bookmaking is illegal and is punishable by imprisonment. (section 337a Penal Code.) It seems clear, accordingly, that in computing Appellant's net income the allowance of any deduction from gross income derived from bookmaking is prohibited by Section 17359.

Appellant contends, however, that a bookmaker's gross income is the difference between his wagers won and lost and that the exclusion or offset of wagers lost from wagers won to compute gross income is not prohibited by Section 17359. The precise question thus is whether the gross income of a bookmaker is the total amount of his winnings or is the difference between that amount and the aggregate amount of bets lost.

Section 17308 of the Revenue and Taxation Code, providing that losses on wagering transactions shall be allowed only to the extent of gains from such transactions, was copied verbatim from Section 23(h) of the Internal Revenue Code, which first appeared

as Section 23(g) of the Revenue Act of 1934. Since the addition of this provision to the Code the federal decisions have consistently regarded gambling losses as deductions from gross income rather than as exclusions from gross income. Humphrey v. Commissioner 162 Fed. 2d 853 certiorari denied 332 U. S. 817; Skeeles v. United States, 95 Fed, Supp, 242, certiorari denied 341 U. S. 948; Roy T. Offutt, 16 T. C. 1214; S Springer v. Truman, T. C. Memo Op., Dkt. No. 15825, February 11, 1949. Consistent with these decisions is a recent ruling of the Internal Revenue Service which provides as follows:

> "...for Federal income tax purposes, all wagering gains must be included in *gross* income, Losses therefrom, by a taxpayer who is not in the trade or business of gambling, are not deductible in determining adjusted gross income as such losses. do not come within the provisions of Section 22(n) of the Internal Revenue Code relating to the determination of adjusted gross income. Nor are such losses deductible from adjusted gross income in determining net income where the taxpayer has elected to use the standard deduction,'! Revenue Ruling 54-339, I.R.B. 1954-34, p. 7.

For Federal income tax purposes, accordingly, wagers lost ' Appellant are regarded as deductions rather than as exclusions from gross income. Considering the similarity of the Federal a State provisions, we conclude that the same is true for State i come tax purposes, subject to the restriction of Section 17359.

If there is any remaining doubt of the legislative intent t prohibit, by the enactment of Section 17359, the deduction of wagers lost by a bookmaker, it may be quickly dispelled by a review of the circumstances which gave rise to the legislation and of the object sought to be achieved thereby.

Section 17359, passed at the 1951 Regular Session, had its origin in a recommendation of the Special Crime Study Commission on Organized Crime. This Commission was created by executive order of the Governor dated November 1, 1947, in which the Commission was directed to include in its reports "the measures considered by the commission to be appropriate for recommenaatic to the executive, legislative and judicial departments of the State, with the object of eradicating groups organized for unla ful purposes from this State and providing increased protection for the people of the State against the inroads of organized crime."

As respects the bookmakers* part in organized crime, the Commission reported:

> "The commission's inquiries into the broad subject of organized crime were commenced by an investigation of the organization of the bookmaking racket as it pertains to horse racing. Initial inquiries were made in this field because, as explained in an earlier report, it was the consensus of opinion of the police officers, prosecutors and other qualified persons attending the Governor's Crime Conference held in November, 1947, that the organization operating the bookmaking racket was in many respects the most menacing in the entire field of organized crime. The commission's subsequent investigations show that this opinion was indeed well-founded." Second Progress Report, dated March 7, 1949, pages 13-14.

In support of its recommendation for a change in the income tax laws, the Commission remarked:

> "The effect on organized crime of such an amendment to the federal income tax law would be very far-reaching. It has been observed:
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> > *If operators of illegal organizations could not deduct expenses, such as salaries, equipment and wire&service costs, or wagers won by patrons, their total receipt would be taxable income, and at today's maximum rate of 77 percent of net income, their taxes would equal or exceed the actual "take home" pay.? /Emphasis added,-/
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> "A similar amendment to the State Income Tax Law would have a good, although not nearly as graat an effect, since the maximum tax rate under the state statute is only 6 percent of net income. However, such an amendment to the state law, even in the absence of a similar change in the federal statute, would bring into the State Treasury hundreds of thousands of dollars each year with little increase in administrative costs, and would have a discouraging, if not blighting, effect on organized rackets within our borders." Final Report, dated November 15, 1950, pages 55-56.
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> The observation. quoted by the Commission is from Alan R. Vogeler, "Change in Tax Laws Could Cut Down Organieed Crime in America",. Saturday Evening Post, August 5, 1950, page 12.

The specific recommendation of the Commission for remedial legislation at the State level was as follows:

> "That the state income tax laws be amended 30 that expenses and losses in criminal enterprises Cannot be deducted for income tax purposes." mphasis added.7 Final Report, dated November 15, 4950, page 58.

In the light of this historical background, and upon consideration of the language of Section 17359, we are satisfied that to the extent of the illegal activities designated therein the Legislature intended to carry out the recommendation of the Commission without any reservations or qualifications,

In keeping with our long-standing rule that in appeals from the action of the Franchise Tax Board we shall refrain from considering attacks on the constitutionality of statutes, in order to make it possible for such issues to receive judicial consideration (see Appeal of Tide Water Associated Oil Company, decided June 3, 1948), we have not considered any of the constitutional issues raise& by Appellant but have proceeded upon the asaumption that none of the laws involved is unconstitutional.

Under Appellant's method of operation the cash actually received or disbursed by him was the amounts received from or paid to his patrons in settlement, at irregular intervals, of the net winnings or losses resulting from the several transactions involved in the settlement. He contends that he reported his income on the cash basis and that his gross income cannot exceed his actual cash receipts from his patrons, Mo authority, however, is cited in support of this contention.

Section 17556 of the Code gives to the Franchise Tax Board the power to prescribe the method of accounting to be employed by a taxpayer if the method adopted by the taxpayer does not clearly reflect his income, In the opinion of the Franchise Tax Board, exercised under the authority-of this Section, the accrual method is the only method which will clearly reflect Appellant's income. Since the temporary records of account kept by Appellant were on an accrual basis, we agree with the Franchise Tax Board's view. Even on a cash basis, however, a receipt of income occurred when amounts owed to Appellant on bets lost by a bettor were offset against amounts owed by Appellant to the bettor, Acer Realty Co v. Commissioner, 132 Fed. 2d 512; Bailey v. Commissioner, 103 Fed, 2d 448,

The final issue presented by Appellant arises from his contention that the Franchise Tax Board erred in its estimate of hi winnings based on the experience of licensed tracks. He testified that he did not pay track odds on bets and that the licensed tracks keep a portion of all bets through the parimutuel machines. Substantially the same testimony, although not directly related to Appellant's bookmaking activities, was given

by a former employee in the City Prosecutor's office of the City of Los Angeles, testifying as an expert on bookmaking practices in general in the Los Angeles area, By his own admission, however, Appellant is unable to determine either the total amount of money wagered with him or the total amount of his winnings, as he does not have records from which to compute these amounts.

It is well established that the taxpayer has the burden of proving a proposed assessment to be erroneous. (Greengard v. Commissioner, 29 Fed, 2d 502; Pennant Cafeteria Co, 5 B.T.A. 293) He may not merely assert the incorrectness of a determination of a tax and thereby shift the burden to the tax administrator to justify the tax and the correctness thereof. Todd v. McColgan, 89 Cal. App. 2d 509. It is equally well settled that where a taxpayer has failed to keep books or records as required by the taxing statute, the tax administrator has the right to look elsewhere, Catherine O'Connor, T.C. Memo. Op., Dkt, No, 24206, January 22, 1954. Turning again to the Second Progress Report of the Special Crime Study Commission page 14, we note that the investigation of bockmaking by that body disclosed that the bettor's winnings from bets placed with a bookmaker are determine by the volume of betting through pari-mutuel machines at the race track, In view of this disclosure, and in the absence of any books or records showing the Appellant's actual winnings, we have concluded that he has failed to establish that the Franchise Tax Board erred in its proposed assessment of deficiencies, or that his taxable income from illegal bookmaking activities was less than estimated by 'that Eoard,

ORDER

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Margaret R, Van Cleave and Jules V. Van Cleave to proposed assessments of additional personal income tax in the amount of $4,969.93 against

each of the Appellants for the year 1951 be and the same is hereby sustained.

Done at Sacramento, California, this 11th day of May, 1955, by the State Board of Equalization,

J. H. Quinn, Chairman

Geo. R. Reilly, Member

Paul R. Leake, Member

Robert E. McDavid, Member

Robert C. Kirkwood, Member

ATTEST: Dixwell L. Pierce, Secretary